SECTION IV

DERIVATIVES, SHORT-SELLING AND TRANSPARENCY

Overview

The pressure on regulators to regulate even more increases substantially during and immediately after financial crises. This crisis has been no different on this front. Unfortunately, quite often market participants, commentators, politicians, and (even!) some academics mistake symptoms for causes and advocate regulation that fixes symptoms rather than getting at the root causes.

- In two of the chapters to follow, Chapter 10 – “Derivatives – The Ultimate Financial Innovation” and Chapter 11 – “Short Selling”, we discuss the case for and against regulation of financial derivatives and short-selling. We argue that financial derivatives such as options and futures allow risk-sharing in the economy and also allow market participants to take focused bets, thereby revealing the information underlying these bets and performing a valuable information generation role for the economy. There is little merit in simply killing this “canary in the coal mine”.
- We do believe, however, that the current crisis has highlighted some shortcomings in the trading infrastructure of relatively newer derivative products, especially credit derivatives. These shortcomings call for prompt regulatory attention, and possibly intervention. In particular, the third chapter in this section, Chapter 12 – “From OTC to Centralized Clearing – the Case of Credit Derivatives”, suggests that the over-the-counter nature of trading in credit derivatives, and the resulting opacity, contributed significantly to **counterparty risk concerns** surrounding the failure or near-failure of significant players such as Bear Stearns, Lehman Brothers and AIG, and discusses the merits of centralized counterparty clearing and the likely design issues involved in ensuring minimum (near-zero) counterparty risk.